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C O N F I D E N T I A L SECTION 01 OF 03 SUVA 000222

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MANILA FOR ADB

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TAGS: EFIN FAID TN CH

SUBJECT: TONGA STRUGGLES TO STABILIZE ITS ECONOMY; HOPES CHINA WILL OFFER A HELPING HAND

REF: A. SUVA 139

- 1B. SUVA 156  
1C. SUVA 210

Classified By: AMBASSADOR LARRY M. DINGER. SECTIONS 1.4 (B) AND (D).

11. (C) Summary: Tonga's economy continues to feel the impact of last year's public servant's strike settlement. The FY 2006/7 budget deficit, even after implementation of a planned "redundancy package" that will result in 700-1000 fewer government workers, will be in the T\$16-20 million range (about USD 8-10 million). The government hopes to fund the redundancy package and deficit through fiscal restraint, selling off government assets such as its share in Westpac Bank of Tonga, and help from donors. The Prime Minister, who politically sees merit in easing monetary policy and softening the austerity program, has asked for a grant from China to balance the budget and a soft loan to help repurchase Tonga's electricity utility from the Crown Prince.

The Chinese Ambassador to Tonga warned that Tonga should not be overly optimistic about the availability of funds from China. It remains an open question how potential loans and grants from China would affect the ADB economic reform program in Tonga, and whether they would be good for Tonga's economy in the long run. "Development Partners" intend to meet with the Government of Tonga in June or July. End summary.

Tonga's Plan to Get Its Fiscal House in Order

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12. (C) Tonga Finance Minister Siosiua 'Utoikamanu told us May 15 that Tonga will be able to meet its wage obligations from last year's strike settlement and balance its 2006/7 budget by reducing the government work force, cutting spending and selling off assets. The key step is implementing a redundancy package that will result in the voluntary separation of up to 1000 government workers, more than one quarter of the work force. As of May 15, 622 employees had expressed interest in taking advantage of the separation package. (Note: on May 16, 'Utoikamanu told Australian and New Zealand officials that he had informally heard the number had increased to the 700-800 range.) The redundancy plan targets service employees such as clerical workers and drivers, and discourages applications from teachers and other workers in short supply. 'Utoikamanu said older civil servants thinking of early retirement and younger employees who had decided to emigrate were two of the main

groups of workers likely to take advantage of the plan.

¶3. (C) The redundancy package will be expensive, said 'Utoikamanu, and some valuable workers will be lost. (We hear several senior and capable civil servants in the Ministry of Finance are among those planning to leave.) Nevertheless, reducing the size of the civil service is imperative for the long-term financial health of the Kingdom.

Redundancy packages for 800 workers, he said, will cost about T\$34 million (USD 17 million). Some of the costs will be financed through an existing Asian Development Bank loan facility that Tonga has only partially tapped up until now, with most of the remainder coming from the sale of the government's 40% stake in Westpac Bank of Tonga. 'Utoikamanu said he is reluctant to part with Westpac, easily the government's most profitable investment, but has little choice. Discussions with Westpac management about selling half of Tonga's stake in the bank are ongoing, he said. The Government plans to offer the remaining half of its shares to private Tongan citizens. After implementing the redundancy package, Tonga will have a budget shortfall in 2006/7 of T\$16-20 million, 11-13% of the budget. This shortfall will be covered by a mix of spending cuts, money remaining from the Westpac sale and, Tonga hopes, external assistance.

¶4. (C) When the budget is stabilized, 'Utoikamanu hopes to reverse some cuts in services. Road maintenance has been badly neglected, he said; police vehicles frequently have no fuel. The government cannot let this situation continue. 'Utoikamanu reaffirmed his commitment to Tonga's unpopular 15% consumption tax, which in 2005 replaced a sales tax and a hodgepodge of import taxes. Going back to the import taxes, he said, is not an option given Tonga's WTO accession commitments. Moreover, those taxes were subject to numerous

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special interest exemptions (read: Royal Family business interests) and were easily avoided by those who knew how to manipulate the system or who to bribe.

Western Donors Take Wait and See Attitude,  
So PM Turns to China

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¶5. (C) 'Utoikamanu understands why western donors have not rushed in to bail Tonga out of a budget crisis of its own making. Donors, he said, are waiting for greater clarity about how political and economic reform in Tonga will play out. This is a reasonable attitude, he said, because economic reform won't work if the right political governance structures are not in place. "Unfortunately," he continued, "I cannot wait. I need to move forward on a budget package now." 'Utoikamanu noted that PM Sevele asked China for T\$12 million in budget support when he met Premier Wen during the China-Pacific Island Countries Economic Development and Cooperation Forum in Fiji in April (refs A and B).

¶6. (C) Sevele also asked Wen for a T\$60 million (US\$30 million) soft loan that Tonga would use to repurchase the former national electric utility (now Shoreline) from the Crown Prince. 'Utoikamanu insisted the latter is only a fall-back option. Tonga still hopes to find a foreign investor who could purchase Shoreline directly from the Crown Prince's investment group. 'Utoikamanu acknowledged that the government needs to accelerate steps to limit Royal Family involvement in the economy, noting Royal involvement in aviation, telecommunications, power generation, etc. Unfortunately, the government doesn't have the money to buy back most assets, and eager investors are few and far between.

¶7. (C) China's Ambassador to Tonga, Hu Yeshun, confirmed to us that Tonga made the two requests for assistance. Beijing has not yet given Tonga an answer, he said. Hu warned that Tonga should not be overly optimistic. Up to now, he said, all of Beijing's assistance to Tonga has been via RMB-funded projects, such as the Tonga high school and renovation of the

Dateline Hotel. Hu questioned whether Beijing would be willing to approve hard-currency grants or soft loans, although it is possible Tonga could tap into the planned RMB 3 billion loan facility Wen announced during the Fiji conference (ref B). (Note: A frequently heard rumor in Tonga is that a Chinese entity gave the Crown Prince a personal US\$30 million soft loan a few years ago. This loan was reportedly related to the Shoreline investment.)

A Development Partners Meeting Planned  
for June or July

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¶ 18. (C) At an informal Development Partners Meeting regarding Tonga held via video conference May 16, representatives from the United States, Australia, New Zealand, the EU, Asian Development Bank (ADB), IMF and the World Bank agreed that future donor assistance should be predicated on the government's acceptance and adoption of the strategic development plan drawn up with the help of the ADB, as well as progress on political reforms. Participants agreed that Development Partners should meet again soon face-to-face to review Tonga's economic and political environment and consider next steps. The meeting is expected to take place in Nuku'alofa in late June or July. An Embassy representative will attend.

PM and Finance Minister at Odds Over Economic Policy?

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¶ 19. (C) Participants in the meeting expressed concern about Prime Minister Sevele's purported attempts to influence monetary policy set by the Reserve Bank of Tonga (RBT). IMF officials later told us that Sevele put pressure on the Bank to lower its statutory reserves level, apparently at the request of the commercial banks. 'Utoikamanu reportedly had to convince the RBT Governor not to resign over the PM's interference. 'Utoikamanu has inquired about getting a loan from the ADB to strengthen the RBT, thinking loan conditionalities could force politicians to accept the Bank's independence. Donors suggested instead that technical assistance from the IMF would be more appropriate.

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¶ 10. (C) As noted Ref C, PM Sevele and FM 'Utoikamanu have different approaches to economic policy. According to New Zealand High Commissioner to Tonga Michael McBryde, Sevele is far more focused on social issues than the Finance Minister, and is therefore reluctant to cut services or implement radical reforms which could negatively impact the poor. Some donors suggest Sevele is primarily focused on facilitating business, given his own supermarket interests. McBryde insists, however, that Sevele and 'Utoikamanu have learned to work together. Tonga, he said, is moving forward on economic reform, though at a pace slower than 'Utoikamanu would have liked.

The Public Has Its Say

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¶ 11. (C) The East-West Center's Sitiveni Halapua, Deputy Chairman of the National Committee for Political Reform, told us economic issues are raised at every community meeting the Committee holds. The most vociferous comments are usually directed at the recently-instituted 15% consumption tax. Halapua said that while Sevele appears to understand the public's concerns about the difficult economy, 'Utoikamanu is widely considered detached and tone-deaf to complaints. 'Utoikamanu needs to do a better job explaining his policies to the public, said Halapua. Halapua believes the government will eventually have to lower or otherwise modify the consumption tax to assuage public opinion.

Comment - Plenty of Economic Challenges Ahead

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¶12. (C) The Government of Tonga appears to have done a reasonably good job maintaining a stable economy since the strike settlement. Despite the higher wages and increased budget deficits that resulted from the wage deal, inflation has remained under control and the Tonga pa'anga has kept most of its strength. Inflation in March 2006 was 7%, up from 5% in February, but down from 12% in February 2005. The pa'anga has depreciated about 3% from pre-strike levels. This performance contrasts with repeated warnings from the ADB that the wage settlement could spark inflation rates of 20% or higher.

¶13. (C) Tonga is not close to being out of the woods, however. Civil service wages, which increased 46% in the 2005/2006 budgetary year, will increase a further 42% in 2006/7 as the second tranche of the wage agreement is implemented. Tight fiscal and monetary policy, along with implementation of 'Utoikamanu's reform package, will be deeply unpopular but appear to be economic necessities. Steps needed to limit the Royal Family's role in the economy are unlikely to take place until far-reaching political reforms are put into effect.

¶14. (C) Tonga's effort to obtain Chinese financial assistance has an interesting ADB twist. We are told China is the ADB's biggest borrower. If China should provide a loan or grant to help Tonga climb out of its self-imposed fiscal mess, that could, in effect, work to frustrate Western donor, including ADB, efforts to press Tonga to implement important political and economic development goals. Bail-outs from China or other donors might ease Tonga's economic pain, but would do little to solve the economic problems created by the strike settlement or resolve the inherent conflicts caused by pervasive Royal involvement in the economy. Easing the economic pain without meaningful restructuring could also reduce the impetus for real political reform. It remains to be seen whether PM Sevele will be willing to persevere with the difficult and often unpopular actions needed to keep Tonga's economy on a solid footing.

DINGER